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Macroeconomic policy and trade integration in Southern Africa[1]

1. Introduction

The question underlying this paper is whether a SADC free trade area requires convergence in macroeconomic variables and policies in the member countries.[2] This question applies both to the initial conditions for getting the free trade area started, and to it being sustainable over time if and when it is established. Behind these question lie another, namely whether the proposed SADC free trade area requires some mechanism, an agency of restraint [Collier, 1991], in order to force member countries to have compatible macroeconomic policies, and therefore macroeconomic conditions.

Before addressing these questions directly, Section 2 considers the reasons for the enduring popularity of attempts to set up free trade areas in Sub-Saharan Africa, and their disappointing track record. Section 3 discusses possible reasons why SADC might be an exception to this record. The leading exception is SACU, so Section 4 examines its long (90 year) history, and whether compatible macroeconomic policies were significant. Section 5 asks whether *setting up* a SADC free trade area will require macroeconomic policy convergence, while Section 6 asks whether a SADC free trade area *could survive* without it. Section 5 concludes that macroeconomic policy convergence is *not necessary* for a free trade area to be established, but that it *is necessary* for it to be sustained, because several of the non-SACU members of SADC need to attract new investment in order to derive positive benefits from the free trade area. Drawing such conclusions as are possible from the analysis, Section 7 discusses what type of institutional arrangement would create lasting macroeconomic stability, that would be convincing to investors, throughout SADC.

2. Free trade areas in Sub-Saharan Africa: rhetoric for, and evidence against

Why do African countries keep trying to establish regional free trade areas, or even continent-wide free trade? Why do they fail? Why has SACU endured? And are there any reasons for thinking that SADC could be an exception?

The public commitment of African governments, to the idea of regional or continent-wide free trading areas, dates back at least to the time when Ghana became independent. President Nkrumah went out of his way to pay serious attention to those future African leaders who were leading the opposition to colonial governments, and thereby created

[1] Helpful comments on earlier drafts from Kennedy Mbekeani of BIDPA are gratefully acknowledged.
[2] In this paper, discussion of SADC does not include the Democratic Republic of the Congo or the Seychelles.

great personal loyalty, together with an acceptance of many of his ideas. One of the most prominent was Pan-Africanism. Ever since that time, it has been virtually impossible to disagree (in public, and especially at African international meetings) with statements in favour of regional or pan-African economic integration. What is remarkable is not so much that this should have happened initially, but that devotion to regional trade areas and Pan-Africanism should have persisted for so long in the teeth of the evidence of its actual success. In practice, there seems to be an acceptance that the rhetoric and reality shall be allowed to diverge, with African ministers making speeches in favour of integration at international meetings, but going back to their countries and failing to take the measures that would be necessary to make it happen.

The history of regional free trade areas in Sub-Saharan Africa is that most of them have either failed, or have stayed in existence on paper with very little actual progress towards their objectives. Within the (broadly defined) Southern Africa region, the failures include the Central African Federation and the East African Community, while the achievements of COMESA remain limited. It has always appeared that some member countries of COMESA are less than totally serious about their membership, because of overlapping and incompatible membership of other regional organisations. For example, it seems that Kenya, Tanzania and Uganda are more interested in re-establishing the East African Community, and that those members of SADC with overlapping membership in COMESA are waiting to see where their interest lies (Lesotho and Tanzania have already left COMESA, and Mozambique has suspended its membership). Only SACU has endured, see Section 4 below.

Judging by the rhetoric, African governments persist in believing that the creation of African free trade areas will generate economies of scale and therefore overcome the problem of small national markets. Unfortunately, this is largely an illusion. African countries can gain access to somewhat larger markets than available domestically, by creating regional trading associations, but such enlarged markets will be extremely small by wider international standards. The GDP of the whole of Sub-Saharan Africa is a fraction more than 1% of global GDP. Perhaps more to the point, the GDP of Sub-Saharan Africa is of roughly the same order of magnitude as the GDP of Belgium, or the Netherlands. The point of this comparison is that those two countries have believed for many years that their economies are too small to flourish independently, so that they were among the founder members of the European Common Market (and before that had created the Benelux free trade area). Moreover, both countries are relatively small geographically, with excellent transport networks; almost exactly the opposite is true of Africa. Communications between, for example, Swaziland and Sudan which are both members of COMESA, are virtually non-existent, and to the extent that they do exist are relatively unreliable and expensive. In other words, expecting significant economies of scale from joining African economies into a single market is an illusion. It is also significant that much of GDP in Africa is still generated by subsistence activity, which generates no monetary demand; and an above average proportion of monetary demand is for basic consumer goods such as food and clothing, in which economies of scale are not significant.

A rather better reason for expecting benefits from regional integration, but one which is emphasised less in the publicly stated objectives in Africa than in Latin America [McCarthy, 1996: 216], is that even within quite small regional markets there should be an increase in competition. In turn, this should lead to greater efficiency and a better chance in the long run of being internationally competitive. The smaller members of SACU have gained in this way from having to compete in the South African market. Indeed, it has been argued that it is more realistic for producers in the BLNS countries to test their competitive ability in the South African market initially, whereas they would not be able to graduate to competition in global markets without this stepping stone being available.

A third possible benefit of regional integration is political. The political and economic bargaining power of African countries might be strengthened if their voice came from regional or continent-wide organisations. Of these, regional organisations are more likely to be effective, because of the extreme difficulty of achieving an agreed pan-African view. There is some evidence that regional groups survive, with good attendance at meetings from heads of state, so long as they achieve some diplomatic recognition and success, but fade away when such gains are small; this is said to have happened in the case of ECCAS, the Economic Community of Central African States [Lancaster, 1995]. In this sense, SADC has been quite successful, although current disagreements over the DRC are undermining the past record of success in dealing with political disputes in SADC, and in individual SADC countries.

3. Might SADC succeed where other regional trade agreements have not?

Are there any reasons for thinking that a SADC free trade area might succeed where other such initiatives have failed, and in particular for believing that SADC is more likely to succeed than COMESA? A great deal of the answer turns on the position of South Africa. South Africa's GDP is about 45% of the Sub-Saharan African total, and 74% of SADC GDP (Nigeria's GDP is less than 10% of the African total). This makes the success of COMESA unlikely, because South Africa has chosen not to join, choosing instead to join SADC. South Africa has not yet ratified the SADC free trade agreement, although President Mbeki said in mid-1999 that South Africa would ratify by January 2000. Clearly, the free trade area would be negligible without South Africa; it also requires the non-SACU members of SADC to join if it is to be more than a reworking of SACU. A reason why South Africa could eventually decide to ratify the SADC trade protocol would be in order to protect its existing markets in the non-SACU SADC countries, especially from Far Eastern competition. On the other hand, South African manufacturers fearful of competition, from Mauritius and Zimbabwe in particular, may lobby successfully to prevent the free trade area from being established.

While the smaller SADC members will no doubt continue to sell most of their exports of primary commodities to developed countries outside the region, it could be argued that a SADC free trade area would make it possible for them to develop non-traditional exports, mainly manufactured goods, by acquiring duty-free access to the South African market. However, free trade might not be sufficient of itself, because (as argued below) new

investment would also be required. These countries have had duty-free access for manufactured goods to be European Union for many years, but have not been able to take significant advantage.
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They might also want to join because of evidence that the small members of SACU have grown faster than their neighbours. Income per capita of the BLNS economies converged on that of South Africa from 1960 to 1989, whereas the economies of most non-SACU members of SADC did not [Jenkins and Thomas, 1997, Mauritius is an esception]. In other words, the BLNS economies responded as expected to the theory of economic convergence, namely that the lower the starting point in terms of GNP per head, the faster the rate of growth, when countries are in a free trading relationship.

Some recent data on rates of economic growth in SADC are presented in Table 1 below (for SADC GNP per head, see Appendix Table 2).[3] The statistics in Table 1 are less convincing, in that the growth rates of the non-SACU members of SADC compare quite favourably with those of the small SACU members. It should be noted that several of the non-SACU members of SADC suffered from South African destabilisation, most obviously in Angola and Mozambique where South Africa supported civil wars, but also in other countries which supported the struggle against apartheid. The BLS countries were less involved.

Table 1. Annual rates of growth of GDP in SADC, 1980-98 (%)

	1980-89	**1990-95**	**1996**	**1997**	**1998**
South Africa	2.2	0.6	3.2	1.7	0.1
Other SACU					
Botswana	11.0	5.0	6.6	7.2	8.3
Lesotho	3.9	5.4	12.7	3.5	-8.6
Namibia	0.8	4.2	3.0	1.8	2.6
Swaziland	2.5	3.5	3.8	3.7	3.0
Non-SACU SADC					
Angola	4.6	- 0.4	12.2	7.3	1.3
Malawi	1.4	3.5	9.5	6.4	3.1
Mauritius	4.4	5.3	5.5	5.3	5.6
Mozambique	0.4	4.9	6.4	14.1	11.2
Tanzania	2.5	3.5	4.2	3.3	*3.8*
Zambia	1.3	- 0.4	6.5	3.5	-1.9
Zimbabwe	5.1	0.5	7.6	4.4	1.6

Sources: Figures for 1980-89 and 1990-5 from CREFSA, 1998, which used IFS, World Bank, EIU and central bank annual reports. Figures for later years from IFS, the South African Reserve Bank website: Committee of SADC Central Bank Governors, and EIU Country Reports (in italics).

[3] Note that the small members of SACU grew faster than South Africa over a longer period, despite colonial neglect. For example, their share of SACU imports rose from 1.3% to 4.1% between 1910 and 1965, as noted below.

However, the analogy may not be valid. Creation of a SADC free trade area may not necessarily have the same effect on economic growth on the new members, as it had on the smaller members of SACU. Firstly, the relative success of the small SACU countries could be attributable to their not having an independent trade policy, rather than to free trade with South Africa. In other words, SACU acted as an agency of restraint in preventing BLNS adopting the trade policies which are believed to have caused the ruin of many African economies.

Secondly, the starting point of the non-SACU members of SADC is different from that of the small SACU members. The latter have always been exposed to competition *within* the SACU market, essentially competition with producers in South Africa , although they are protected by the common external tariff from non-SACU competition so that relatively few BLNS producers are internationally competitive. Any producers setting up in one of the BLNS countries have to be able to compete with imports from South Africa from their first day of operation. There are some minor exceptions to this, in that some sectors are reserved for citizens, but these tend to be such activities as small-scale retailing, and taxi services. Manufacturing is not a reserved occupation. This means that manufacturers must be competitive with South African producers. This has the advantage that some of these producers have been able to develop exports to South Africa. Although exporting requires a higher degree of competitiveness than being able to compete with imports, because of transport costs, the transition from competing with imports to competing in the South Africa export market has proved a step that some producers have been able to take. In addition, some manufacturers have set up in order to service the South African market, particularly in Lesotho and Swaziland [BIDPA, 1998].

There are some minor exceptions to the statement that all manufacturers in BLNS have to be competitive with producers in South Africa, because the SACU agreement allows for the temporary (up to eight years) tariff protection of producers in the BLNS countries. But Botswana, for example, has only ever protected two producers in this way; they both failed. As a result of this restraint on tariff protection, within SACU, the BLNS countries have not created protected monopoly manufacturers. This was done in many other African countries, including several of the non-SACU members of SADC. It had generally disastrous consequences, because the "infant industries" never succeeded in becoming internationally competitive. In addition, those which were state-owned tended to make large losses.

Exposing some non-SACU countries in SADC to free trade with South Africa could have a doubly damaging effect. Firstly, their existing manufacturing sectors would be unable to compete with imports from South Africa, so that much of it would be driven out of business. Secondly, their existing industry would not be able to take immediate advantage of access to the South African market, so that they would gain little or nothing from a SADC free trade area in the short term, and probably not much in the medium term.[4]

[4] These adverse effects would be reduced if, as has been discussed, the lowering of tariffs within SADC were to be asymmetrical, with South Africa lowering its tariffs sooner and faster than the other members.

In the long term, those economies and sectors of manufacturing which are currently uncompetitive regionally, might be able to sell to South Africa eventually, provided that other aspects of their economic structure and situation were favourable. However, this would depend on their being able to attract *new* industry capable of taking advantage of the free trade area in general, and of exporting to South Africa in particular. Unfortunately, it would be likely that their acceptance of the free trade area would have disappeared and led to withdrawal before such long term benefits could accrue.

The South African government has offered asymmetry, under which the non-SACU members of SADC would be required to reduce tariffs on imports from South Africa more slowly than South Africa would reduce its tariffs on imports from them. But this would merely postpone the possibility of increased efficiency, and would do nothing to attract investment in manufacturing capable of exporting to South Africa.

For these reasons, previously protected manufacturing sectors are in a quite different position to the manufacturing sectors of the BLNS countries, so that assuming the same advantages of free trade with South Africa would be wrong.

Not all of the non-SACU manufacturing sectors in SADC would be adversely affected in this way. Mauritius has a competitive manufacturing export sector, and some sectors in Zimbabwe are capable of competing in the South African market, as shown by the unwillingness of South Africa to renew the bilateral Zimbabwe trade agreement. Either it has already happened, or they have not built up a protected manufacturing sector in the first place. In Zambia, the country's trade regime has already been liberalised. Existing manufacturing industry was unable to compete with South African imports, and was even less able to develop exports. The increased efficiency that is supposed to occur upon opening up an economy to international competition assumes that producers will swim rather than sink, but many Zambian manufacturers sank. So Zambia would not be much harmed by a SADC free trade area, because the damage has already been incurred; but nor would there be much expectation of gains from the export of manufactured goods to South Africa and the rest of SADC from the existing manufacturing sector.

Mozambique did not built up a protected manufacturing sector, because of the war. Much of the investment in its rapidly recovering economy (recent growth rates have been in double figures) has been premised on trade with South Africa, and would not probably be damaged by the creation of a free trade regime.

Malawi and Tanzania, and to some extent Zimbabwe (leaving aside Angola because of the war situation) do have protected manufacturing sectors. That of Tanzania is probably doubly inefficient, because most of it was developed by and remained in the public sector.

It can be argued that the non-SACU members of SADC cannot afford to be excluded from the South African market, and will therefore choose to join a SADC free trade area if otherwise their exports would be subject to the common external tariff of SACU. Although the common external tariff has been reduced, and is expected to be reduced

further because of South Africa having joined the WTO as a "developed country", the average tariff remains significant. Moreover, the non-SACU members of SADC are very conscious of their bilateral trade deficits with South Africa, despite the irrelevance of bilateral trade deficits in comparison with overall current account balances. They might therefore see a SADC free trade area as an opportunity to reduce those deficits.

It is possible, perhaps even likely, that these considerations will mean that SADC does indeed succeed in *creating* a free trade area, but it is less likely that it will *persist* because of the strong pressures towards disintegration that will exist.

The commonest reason by far for the failure of established free trade areas is a belief, correct or not, that one country (usually the more economically advanced) is getting a larger share of the benefits than accrues to other members. In the more extreme cases, the majority of members believe that the supposedly favoured country is not only getting a more than acceptable share of the benefits, but that the other members are actually worse off because the favoured country is gaining at their expense. This was the case in the East African Community which foundered in the 1970s, with Kenya cast as the villain by Tanzania and Uganda.

Logically, the less advantaged members of a free trade area should choose to maintain it if they are better off than they would be without it, but in practice they do not if one member is perceived to gain more than the others. If that was the case for Kenya in the East African Community, the expectation of it happening in a SADC free trade area must be several times stronger, because the economy of South Africa is not only totally dominant in size (roughly 75% of total SADC GDP), but is even more dominant in manufacturing capacity (nearly 85% of manufacturing capacity in SADC) and level of technical development. To make matters worse, South Africa already has large bilateral trade surpluses with other SADC members.

Another possible reason for arguing that the dominance of South Africa in the Southern African economy might make a SADC free trade area an exception, to the record of failure of regional trading associations, is that the one successful example is SACU, which has existed for nearly 90 years. South Africa is of course even more dominant in SACU than it would be in a SADC free trade area. Examining the reasons why SACU has survived, and why it is currently being renegotiated, might throw some light on the prospects for SADC, therefore. In particular, in the context of this paper, the relevance or not of macroeconomic policy convergence to the survival of SACU should be examined.

4. The significance, if any, of SACU

The facts about SACU are fairly simple. When it was first established in 1910, it was no more than a recognition of the status quo. It may even have been thought of as a temporary arrangement prior to the absorption of the three small members into South Africa. The Act of Union contained a clause saying that the three High Commission Territories would eventually be incorporated into the Union of South Africa. Fortunately, the Act also said that this would not happen without the consent of the local people in

each territory. Although the British did almost nothing else for the three territories, they did prevent incorporation despite great pressure at times from South African governments, for example on Botswana through refusal to buy Botswana's beef [Hubbard, 1981].

Apart from establishing free trade within the four countries, and a clause guaranteeing free transit across each others' territories, the main significant element of the SACU agreement was the revenue-sharing formula for the distribution of the revenues collected from the common external tariff. Each member country received a percentage of the total amount of duty collected, based on the relative size of the four economies at that time, which meant that 98.69% went to South Africa. The percentages were fixed, so that when the three smaller economies grew faster than that of South Africa, there was no matching increase in their share of the SACU revenue pool. There was a readjustment in 1965 of the shares of the three smaller countries, but their combined share remained the same at 1.31% even though by that time their combined share of imports had risen to 4.1%.

There was throughout this period a limited advantage to the smaller countries, in that their customs officers did not have to collect revenue on intra-SACU trade, but only on the minor proportion of goods imported from outside SACU. After the renegotiation of the SACU agreement in 1969, customs officers had to collect statistics, on which subsequent claims for each country's share of the SACU revenue pool were based. This increased the administration required, but still made fewer demands on the very underdeveloped civil service in each of the small countries than would have been made by independent national customs areas. On the other hand, the common external tariffs were imposed exclusively in South Africa's interests, without consultation with the smaller members, to provide protection for South African manufacturers.

Why have the three smaller countries tolerated the total dominance of South Africa in trade policy (and huge bilateral trade deficits with South Africa)? Until the 1960s they were so weak, both economically and politically, that they had little choice. For the first 50 years or more of the SACU agreement, the High Commission Territories were ruled by the British High Commissioner in Cape Town, who paid considerably more attention to relations between Britain and South Africa than to the interests of Bechuanaland, Basutoland and Swaziland. As a result, the colonial power took almost no interest, and the territories themselves had completely negligible bargaining power. It is probably significant that there was no upward adjustment of the BLS revenue share until after they had gained their independence. Thereafter, the advantages of large customs revenues, with minimal administrative cost, outweighed the disadvantages, or appeared to do so.[5]

The changes that were negotiated in 1969 were perceived to have shifted the revenue formula from a bias in favour of South Africa, to a bias in favour of the three smaller countries. The revised formula was regarded as being relatively generous, and went

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[5] This was despite research showing that the price-raising effect of the common external tariff, net of the effect of the multiplier in the revenue formula, resulted in a net cost, in the case of Botswana of up to 3.25% of GDP over a period of four years in the late 1980s [Leith, 1992].

some way towards compensating for loss of policy discretion, the price raising effect of the common external tariff, and the tendency of investment to be attracted to the core rather than to the periphery. It gave the three smaller countries a revenue share based on their share of imports and products subject to excise duties into the SACU area, multiplied by 1.42. There was a further change in 1977, setting upper and lower limits (of 17% and 23%) on the average rate of revenue, which turned out to be favourable to the BLNS countries; the 17% minimum has been the effective rate for many years. The significance of customs union revenue became very large, amounting to some 50% of total government revenue in Lesotho and Swaziland for example.

The revenue formula has been criticised, on the grounds that at times of rapid growth the delays in receipt of increased SACU revenue were large enough to offset the benefits of the multiplier in the revenue formula. Nevertheless, the smaller countries sought a new agreement, mainly because of South Africa's monopoly of decision making. On the other hand, South Africa wanted a new agreement because it regarded the revenue formula as being too generous to the smaller countries. In particular, the revenue owing to BLNS does not decrease if the revenue pool decreases. This has been happening, following the shift to VAT in South Africa and reductions in the common external tariff.

It is roughly correct, therefore, to say that the two major issues in the current renegotiation of SACU are to reduce the bias in favour of the smaller countries in the revenue-sharing formulae, and to give the latter some say in tariff and other trade policy issues. It seems likely that the unwillingness of the South African Government to relinquish sole control of tariff policy is a principal reason for the current negotiations failing to reach a conclusion, over an extended period. On the other hand, South Africa has apparently been willing to contemplate a new revenue-sharing formula which would give roughly the same revenue to the smaller countries, but which would reduce their customs union revenue if the total paid into the pool were to fall. In practice, that is exactly what is expected to happen, as a result of further reductions in the common external tariff to conform with WTO membership, and because of the new free trade agreement with the European Union. The latter would have a particularly severe effect on government revenue in Lesotho and Swaziland, and would have a significant effect on the other two countries as well [BIDPA, 1998].[6]

Despite these difficulties and disagreements, SACU has lasted for a long time, very much longer than any comparable arrangement in the rest of Africa. It is relevant therefore to ask whether SACU's survival has depended on macroeconomic policy convergence, and whether the latter, if it has played a part, has depended on agencies of restraint.

The history of SACU is relatively unhelpful in indicating whether macroeconomic policy convergence was significant in SACU's survival, and therefore whether it would be

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[6] It has been estimated that the EU/SA FTA would reduce the current size of the SACU revenue pool by 31% if the protocol items (for example textiles and cars) continue to be protected, and by 51% if they are eventually imported duty free from the EU into South Africa. This would reduce total government revenue in Swaziland by 14%, or 23% in the worst case. The figures for the other countries are Lesotho (13/21%), Namibia (9/14%) and Botswana (5/9%) [BIDPA, 1998: 44].

significant for SADC. For most of the period of SACU's history, the four countries used a common currency, that of South Africa. Namibia, when it became independent in 1990, joined SACU and continued to use the rand de facto. Each of Lesotho, Namibia and Swaziland has issued its own currency, but each national currency exchanges on a one-to-one basis with the rand, which is allowed legally to circulate alongside each national currency. Only Botswana has made a significant break, leaving what is now called the Common Currency Area (formerly the rand Monetary Area) in 1976.

What this amounts to it is that Lesotho, Namibia and Swaziland are bound to have similar inflation rates to that of South Africa, because money and goods can flow freely between the four countries, and because the central banks of the three smaller countries have limited or zero powers to finance budget deficits by money creation. With their exchange rates fixed at 1:1 to the rand, and inflation rates close to that of South Africa, they have very narrowly fluctuating real bilateral exchange rates with the rand. Botswana does have those powers, but has had budget surpluses in the great majority of years since 1976, so that there has been no temptation to indulge in inflationary finance. Botswana did have a budget deficit of P1.5 billion (R2.0 billion, about 6.2% of GDP) in 1998/99, but the Government's accumulated financial surpluses at the Bank of Botswana could finance such a deficit for 12 years without domestic borrowing being necessary.

Meanwhile, the Botswana government has consistently maintained a near-constant real exchange rate against the rand, as a matter of policy, so that trade between Botswana and South Africa (and to the very limited extent that it exists, between Botswana and the other SACU members) has not been disrupted by macroeconomic divergence. The Pula has risen in nominal terms against the rand, from its initial value of R1 to its current value of approximately R1.32, but over the long term inflation in Botswana has been less than in South Africa (see Table 2), leaving the real exchange rate fairly constant. Botswana is extremely unusual in not having abused the opportunities created by having its own central bank. However, Botswana is also extremely unusual in having had such a favourable budget position for more than 20 years. Appendix Table 1 shows some of the extraordinary currency depreciation that has taken place elsewhere in Africa in most of the countries which created their own independent central banks and monetary systems.

Overall, the evidence suggests that the four smaller members of SACU have gained from membership, as suggested by the convergence of income per head. The extraordinarily rapid economic growth of Botswana is attributable more to the growth of diamond exports than to membership of SACU; but the other small members of SACU have also grown faster than South Africa, and the absence of convergence in the rest of SADC (from 1960 to 1989) suggests but does not prove that SACU had a significant influence. The absence of convergence in the rest of Southern Africa can also be attributed to civil wars, several of which were actively stimulated by the apartheid government.

Undoubtedly, the benefits within SACU were not hindered by the convergence of macroeconomic policy. What cannot be said is whether similar inflation rates and other evidence of macroeconomic policy convergence were *necessary* for BLNS to drive benefits from SACU. Moreover, it is not possible to know whether Lesotho, Namibia

and Swaziland would have abused the opportunity provided by independent central banks and monetary systems, if they had followed Botswana in leaving the Common Monetary Area. It is arguable that they would have, on the evidence of the majority of countries in Africa with independent central banks and no external agency of restraint (see Appendix Table 1).

On the other hand, it could be argued that their governments have been fundamentally conservative, as shown by their unwillingness to leave the Common Monetary Area, and that this indicates that they would have pursued conservative fiscal and monetary policies *with* independent central banks (in particular, Swaziland has pursued a very conservative fiscal policy, despite having negotiated a limited right to borrow from its central bank, see Harvey, 1998). The experience of SACU, therefore, does not help in deciding whether macroeconomic policy convergence is necessary for the success of a free trade area. A more general analysis of this question follows in the next Section.

5. Will setting up a SADC free trade area require macroeconomic policy convergence?

There are strong arguments that a common currency area requires macroeconomic policy convergence. These arguments were accepted, for example, by the European Union in introducing the Euro. It does not seem to be necessary, however, for similar conditions to apply to the establishment of a free trade area. Again, the experience of the European Union supports this proposition, in that it was created, and proved sustainable, without macroeconomic policy convergence, and indeed with some quite weak currencies operating alongside very strong ones. It may therefore be something of a coincidence that four out of the five countries in SACU are members of a common currency area; as argued above, it did not do any harm, but it is difficult to argue that it was a necessary condition for SACU sustainability.

Countries in a free trade area can have different inflation rates, changing nominal exchange rates, and different levels of budget deficit. However, if country A has a higher inflation rate than country B, it is essential that country A allows its currency to depreciate against currency B, since otherwise trade will be unbalanced by a changing bilateral real exchange rate between the two currencies. If country A does not allow its currency to depreciate, its imports from country B will appear increasingly competitive compared with domestic goods, whose costs will have been driven up by domestic inflation. Similarly, exports from country A to country B will become increasingly uncompetitive. A bilateral current account deficit does not matter if the overall current account is in balance, or is being financed in a sustainable way. However, if country A has a higher rate of inflation than its other trading partners, and does not adjust its nominal exchange rate to maintain a competitive real exchange rate, then its current account will not be sustainable. Secondly, as noted above, unbalanced bilateral trade may cause political difficulties for a regional trade agreement, even if overall trade balances are sustainable.

Put slightly differently, countries in a free trade area should be willing in the short run "to

abandon the use of the exchange rate as a nominal anchor (and/or a mechanism for delivering rents to favoured groups), and over the longer run, [must be willing] to exercise the fiscal restraint consistent with low inflation" [Oyejide et al. 1997: 5, summarising O'Connell 1997]. The benefits of a free trade area will be very much less, and collapse more likely, if bilateral real exchange rates are incompatible with the growth of *two-way* trade.

There was a clear example of this type of problem in the early 1990s in the bilateral trade of Botswana and Zimbabwe. Botswana is not only a member of SACU, but has a bilateral free trade agreement with Zimbabwe dating from 1956. During the 1980s, Botswana's manufactured exports to Zimbabwe grew rapidly, to the point where Zimbabwe was importing some two-thirds of Botswana's total manufactured exports. In 1991, the Zimbabwe dollar fell by 48% in US$ terms. In the following year, Botswana's textile exports (the leading manufactured export category at that time) fell by 38% (in US dollar terms). Interestingly, textile exports have subsequently recovered to their previous level (in real terms), largely by switching to the South African market, with which the bilateral real exchange rate is stable within narrow limits.[7]

On the basis of the analysis to this point, a SADC free trade area may well be established. The driving force would be the widely held belief that regional trading arrangements are politically desirable and economically beneficial, and a desire not to have exports excluded from duty-free access to South Africa.

However, a SADC free trade area will not have much chance of *surviving,* because a significant number of the non-SACU members of SADC do not have the capacity at present to increase their exports to South Africa. They would need, therefore, to attract the investment in new capacity that would make such export growth possible, and this *would* require convergent macroeconomic policy together with other necessary conditions, as is argued in the following section.

6. Will a SADC free trade area *survive* without macroeconomic policy convergence?

It is argued above that some of the non-SACU members of SADC cannot at present expect to increase their exports to South Africa, because their manufacturing sectors are not regionally competitive. If this is correct, the survival of a SADC free trade area will depend on those countries being able to attract new manufacturing investment. This must be without tariff or other forms of protection within SADC, so that it is capable of being competitive within that free trade area. In turn, this *will* depend on establishing a macroeconomic environment attracted to domestic and foreign investors, together with adequate infrastructure (functioning public utilities and transport systems).

[7] Botswana chose not to end the bilateral trade agreement with Zimbabwe, despite the adverse change in bilateral trade. During the 1980s, the increase of Botswana exports to Zimbabwe induced the Zimbabwe government to close the border to trade between the two countries on more than one occasion. It was reopened because Botswana was able to show that Zimbabwe had net positive earnings of foreign exchange from its bilateral trade with Botswana.

Note that the degree of macroeconomic stability that would be required is not as great as that established for the creation of the Euro, most notably inflation rates of 3% or less. It will be sufficient for the non-SACU members of SADC to attain inflation rates equal to or less than that of South Africa (and the rest of SACU). The latest inflation rate for South Africa is 4.6%, but it is widely believed that the underlying rate is nearer 7 or 8%. The actual inflation rate is probably less important than maintaining a low and stable rate over an extended period, or in some other way creating the expectation *in the minds of investors* that it will be stable.

This Section therefore examines progress towards this objective, and whether macroeconomic balance (if and when it is achieved) is not only likely to be sustained, but is likely to be perceived as credible and sustainable in the eyes of investors.

6.1 *The current degree of macroeconomic convergence in SADC*

In this context, the prospects for the survival of a SADC free trade area, if it is indeed established, have slightly improved since the 1980s. A number of the non-SACU members have embarked on structural adjustment programmes. This has involved liberalisation of the trade account, and movement towards more realistic real exchange rates. However, not all non-SACU exchange rates are now market-determined, and there has been greatly varying progress in the reduction of rates of inflation, with some reversals.

Inflation

At one extreme, Mozambique's inflation was between 40% and 50% between 1980 in 1986, but was reduced to 5.5% in 1997, and prices actually fell (by 1.3%) in 1998. This achievement does not necessarily give Mozambique's macroeconomic policy considerable credibility, because there is always the possibility of policy being relaxed and inflation rising to previous levels. This is what happened in Zimbabwe, where inflation was anyway reduced only marginally, from 26% in the first half of the 1990s, to just below 20%, before it rebounded to its present level of more than 50%.

Something similar happened in Malawi, with a sharp reduction in inflation in 1997 (from 38% to 9%), but a return to a 30% rate in 1998. Zambia's inflation has been reduced from its triple digit levels in the first half of the 1990s, but remains above 20% This appears to indicate a failure to implement its structural adjustment programme successfully, despite the introduction of a cash budget which should have eliminated all inflationary pressure from that source. From the investor's point of view, Zambia continues to suffer from macroeconomic imbalance. Further details of inflation rates in SADC are shown in Table 2 below.

Table 2. Inflation in SADC countries, 1980-98

	1980-89	1990-95	1996	1997	1998
South Africa	14.6	11.8	7.4	8.5	7.0
Other SACU					
Botswana	10.8	12.5	9.8	8.6	6.7
Lesotho	13.8	12.9	9.3	8.5	7.8
Namibia	13.0	11.8	8.0	8.8	6.2
Swaziland	14.2	12.7	12.5	9.7	7.5
Non-SACU SADC					
Angola	-	870.3	905.3	111.2	91.1
Malawi	16.8	30.8	37.6	9.1	29.7
Mauritius	11.2	8.2	6.6	6.8	4.7
Mozambique	45.1	47.5	45.0	5.5	- 1.3
Tanzania	30.1	28.9	19.7	16.1	12.8
Zambia	38.4	117.7	46.3	24.8	31.6
Zimbabwe	12.8	25.9	21.4	18.7	31.8

Notes: (1) Figures for 1980-89 and 1990-5 from CREFSA, 1998, which used IFS, World Bank, EIU and central bank annual reports.
(2) Figures for later years from IFS, except those in square brackets which are from other sources, mostly EIU Country Reports, and may not therefore be comparable.

Budget deficits

Although SADC countries have at times suffered from imported inflation, the commonest cause has been budget deficits financed by central banks (Table 3). There have been someimprovements, but also some reversals. Note however that there is far from being a one-to-one correlation between budget deficits and inflation, among other reasons because of pegged exchange rates, price controls, and other non-market factors.

Table 3. Budget deficits as percentage of GDP, 1980-98

	1980-89	1990-95	1996	1997	1998
South Africa	- 3.3	- 6.5	- 5.3	- 4.7	- 3.0
Other SACU					
Botswana	+ 7.7	+ 5.7	+ 9.4	[+ 4.3]	[- 7.1]
Lesotho	- 5.9	- 4.5	+ 2.9	+ 1.7	[+ 0.4]
Namibia	- 13.5	- 6.9			-4.1
Swaziland	- 2.1	- 0.5	- 4.1	+ 0.0	+ 0.3
Non-SACU SADC					
Angola	- 11.1	- 25.7			
Malawi	- 12.3	- 13.3	- 5.5	[- 3.9]	[- 4.0]
Mauritius	- 6.2	- 2.9	- 4.0	- 4.0	[- 2.2]
Mozambique	- 23.5	- 25.5	- 17.0	[- 3.4]	[- 3.9]
Tanzania	- 10.1	- 6.5	- 0.4	+ 1.8	[- 5.6]
Zambia	- 15.1	- 12.4	- 2.6	- 1.9	- 4.3
Zimbabwe	- 7.8	- 10.0	- 10.3		[10-12] (a)

Sources: as for Table 2.
Note: (a) Zimbabwe budget deficit for 18 months to October 1998 stated officially as 4.9% of GDP. This excludes the cost of involvement in the Congo war. EIU estimates the real deficit at 10-12% of GDP.

There is evidence that over the 1970s and 1980s, the bilateral real exchange rates against the rand of the non-SACU members of SADC tended to return to earlier levels (of the 1960s, before inflation rates shifted upwards). However, shorter term fluctuations have been very large, and in many cases returned to previous levels only after several years. This tendency to revert eventually to some sort of equilibrium, even if it still exists, is therefore insufficient to establish favourable investment conditions [Harvey and Hudson, 1993]. Although previously overvalued exchange rates against the rand have been substantially corrected at times, considerable volatility remains, and in some cases real exchange rate depreciation has been reversed [Jenkins and Thomas 1998: 79-81].

A further problem, not evident from Table 3, is that the budget deficits are shown after the receipt of grants from donors. From the point of view of short-term control of inflation, this way of presenting the data gives the right impression. Grants in the form of foreign exchange make it possible to increase supply by paying for more imports. They are therefore just as good as government revenue in reducing the inflationary impact of government spending. However, heavy dependence on grants to reduce budget deficits may not be sustainable.

Structural Adjustment Facilities (SAFs), and more recently Extended Structural Adjustment Facilities (ESAFs), were introduced in order to make it possible for developing countries to take longer in stabilising and restructuring their economies. The repayment terms are an improvement, but the release of successive tranches of these longer term loans depends on success in meeting loan conditions at frequent intervals, for example quarterly. Both Zambia and Zimbabwe have had IMF and World Bank support withdrawn for failing to meet this short term conditionality.

Aid and aid conditionality

In recent years, moreover, virtually all donors have united with the IMF and the World Bank in withdrawing financial support from countries which do not have IMF/World Bank agreements, or where such agreements break down as a result of recipient countries failing to satisfy regular checks on progress.

The credibility of macroeconomic stability in those SADC members heavily dependent on aid, depends on how likely it is that current levels of donor support will be sustained. That depends, in turn, on recipient countries adhering strictly to both economic and political conditions. Economic conditions now include not only such long-established indicators as inflation, budget deficits and interest rates, but also structural changes such as privatisation. Political and political/economic conditions can include such issues as human rights, involvement in regional wars, and the reintroduction of controls (such as price controls and exchange controls) disapproved of by the IMF.

The increased range of conditions may have been introduced for good reasons, but from the point of view of creating a favourable investment climate it increases the ways in which IMF/World Bank agreements can break down. In turn, this has made investment more risky, and frequently so risky that little or no foreign investment has taken place.

Table 4. Aid as a percentage of imports in SADC, 1980-98

	1980-89	**1990-95**	**1996**	**1997**
South Africa	-	1.1	1.1	2.3
Other SACU				
Botswana	15.6	5.4	4.6	4.0
Lesotho	21.9	15.4	11.8	11.6
Namibia	4.7	9.1	9.6	
Swaziland	9.2	7.4	4.5	4.7
Non-SACU SADC				
Angola	8.5	21.1	18.9	
Malawi	55.9	79.2	75.5	50.0
Mauritius	6.9	3.5	2.1	2.3
Mozambique	59.3	143.4	103.2	[166.7]
Tanzania	61.6	68.3	100.1	110.5
Zambia	33.6	95.2	43.1	86.3
Zimbabwe	15.9	21.4	12.9	[17.9]

Notes: as for Table 1

From Table 4, it is immediately obvious that Malawi, Mozambique, Tanzania and Zambia are desperately dependent on recurrent inflows of aid. There are two ways of looking at this type of situation. On the one hand, any breakdown of relations between a government and the aid donors could absolutely cripple the economy, so that even if

inflation is currently low and macroeconomic stability appears to have been achieved according to other indicators, there must be serious doubts about its sustainability. In other words, investors would tend to be wary of the longer-term prospects.

On the other hand, it can be argued that in the more extreme cases of aid-dependence, with aid at more than 100% of imports, government simply cannot afford to disagree with the aid donors, because the economic effect would be completely devastating. Such a very high degree of aid-dependence would tend therefore towards a curious sort of in-built stability, created by the aid-dependence itself. However, it would take a risk-averse or politically naive investor to commit significant resources on the basis of this argument. It explains why even those countries held up by the IMF as having pursued structural adjustment programmes successfully over an extended period, for example Ghana, have attracted very little foreign direct investment (other than in mining enclaves, with the export revenue deposited in escrow accounts abroad under the control of the foreign investor).

Further problems about very heavy dependence on aid are firstly that aid tends to be tied, which sharply increases costs, and a high proportion of it (typically up to 50% in Africa) goes on technical assistance. Both of these aspects of aid-dependence reduce confidence among investors. Secondly, if export prices recover, for example copper prices in Zambia, there is a strong likelihood that the government will immediately abandon IMF-induced macroeconomic policies, and spend inflows from exports quite differently from the way that inflows of aid had to be spent. This is again a source of instability, or rather a potential source of instability in the eyes of investors. It means, therefore, that the IMF is not a credible external agency of restraint.

The implications are not very attractive in the short term. Aid-dependent economies need a sustained period of sound macroeconomic management, combined with a period of rapidly growing exports, in order to reduce their aid-dependence. In addition, governments need to move from sound macroeconomic policies forced on them by the IMF, the World Bank and the other donors, to sound macroeconomic policies adopted willingly so that they are less likely to be abandoned as a result of a breakdown of donor relations, or a recovery of the country's traditional export earnings. It is particularly hard for governments with a poor track record of economic management to create the necessary credibility, although, as with new management in a previously failing company, new governments have a slightly better chance of convincing investors of their commitment to new policies.

In addition to those countries with aid-dependence above 40% of imports shown in Table 4, it would appear that Zimbabwe is also very aid-dependent, judging from reports in the press. However, the economy does continue to function during periods when disputes between the Zimbabwe government at the IMF have not been resolved. This suggests that the Zimbabwe economy has some capacity to respond to the opening up of South Africa as an export market. This argument is supported by the fact that South African producers of textiles and clothing (and producers in some other sectors) have lobbied hard to prevent the renegotiation of the South Africa Zimbabwe trade agreement. South

African producers would not be so active on this issue if Zimbabwe did not have some capacity to export to South Africa at competitive prices.

Of the other non-SACU SADC economies, Angola is obviously not in any position to attract investment in export manufacturing. This apparently leaves only Mauritius of this group of economies to add to Zimbabwe as being capable of responding to the opportunities provided by a SADC free trade area.

It is just possible, though, that the Mozambique economy may have slightly greater potential than the other aid-dependent economies. The reason for making this suggestion is that the Mozambique economy did not have a recent period of manufacturing development behind high tariff barriers. Nor did it inherit monopoly state-owned manufacturing firms. Essentially, most of the Mozambique economy was destroyed by the war, so that it is starting afresh. In other words, Mozambique may be able to start to build up a new and regionally competitive manufacturing industry, without having to be concerned with how to get rid of old and inefficient firms. It may be wrong, though, to make too much of this argument. Despite the very rapid rates of economic growth in recent years in Mozambique, there must be a long way to go before Mozambique can take significant advantage of free trade with South Africa.

External indebtedness

The other SADC economies either have severe macroeconomic instability, or a fragile stability which is highly dependent on aid inflows , or a much-disliked macroeconomic policy likely to be abandoned as soon as donor support is not necessary. To this could be added the overhang of external debt, as another indicator which probably means that the highly indebted economies will find it difficult to take advantage of a new trading arrangement.

Table 6. Present value of external debt as a percentage of GDP, 1996

SACU		***Non-SACU SADC***	
South Africa	18	**Angola**	310
Other SACU		**Malawi**	76
Botswana	[14]	**Mauritius**	45
Lesotho	33	**Mozambique**	411
Namibia	[11]	**Tanzania**	114
Swaziland	[19]	**Zambia**	161
		Zimbabwe	67

Sources: World Bank *World Development Report 1998/99: 230-1*; figures in square brackets are external debt as a percentage of GNP from World Bank *Global Development Finance 1999.*

Relevance of macroeconomic convergence to sustaining a SDAC FTA

The argument can be turned slightly on its head. The currently very rundown economies in SADC need every possible opportunity to help them to recover, and grow past the

levels (of income per head, delivery of public services, and quality of infrastructure) that they reached 10 or 20 years ago. One of those opportunities would be the opening up of the South African market. The SADC economies have a significant advantage, compared for example with the rest of Sub-Saharan Africa, in having such a large economic neighbour, not just as a potential export market but as a potential source of manufacturing investment. South African firms are far more likely to invest in such countries as Malawi and Zambia than non-regional investors.[8] It is notable, for example, that most of the manufacturing investment in Botswana has come from the SADC region, with only a few recent exceptions (mainly Far Eastern firms prevented by quotas from increasing their exports of textiles and clothing to Europe and America).

The issue then changes. Instead of arguing that a SADC free trade area is unlikely to succeed because of the unattractive investment conditions in several of the key economies, it could be argued that opening up the South African market is a necessary if not a sufficient condition for economic recovery and growth in the region. This potential contribution will be of little use if the SADC free trade area is abandoned quickly by those countries which perceive either that they have gained little, or that most of the gains have gone to South Africa. The problem then is to find some way of making a SADC free trade area reasonably attractive to all its members *in the short term*, in order to give longer term benefits a chance of being achieved. If the arguments above are correct, this means that a way must be found quickly to generate new investment capable of exporting to South Africa (and to a much lesser extent to the rest of SADC). It cannot wait for individual countries to sustain sound policies for long enough to establish their individual credibility. Those individuals SADC countries with a past history of instability would need many years of macroeconomic stability to achieve the credibility necessary for investment, acting on their own.

What can governments do?

There is nothing that governments should do directly, in the sense of investing themselves in export-oriented manufacturing (and other export-oriented activities, there are some services which might contribute). African economic history makes it unlikely that government investments in manufacturing will be anything but a disaster. Similarly, the history of directing investment to areas where it would not willingly go, whether within a single country, as for example "border" firms in South Africa, or within a regional trading area, is that it does not work. The firms themselves struggle to make a profit without any subsidy, and multiplier effects do not emerge. Some action is possible, for example investment in infrastructure; the South African Industrial Development Corporation has started on this. The South African government has also raised the limits under exchange control rules of outward investment by South African companies in SADC. Nevertheless, it is difficult for the South African government, donors or domestic governments to induce private sector investment in the SADC periphery if other conditions are fundamentally unfavourable, or if favourable conditions are seen to be unstable and therefore lack credibility.

[8] Some South African investment has taken place in recent years, notably in Malawi, Mozambique and Zambia, but relatively little of this investment is directed at exporting to South Africa.

This brings the argument full circle. The most effective government action, whether by individual governments or by a regional institution, would be to speed up the process by which sound macroeconomic policy (supposing that it has been established) acquires medium and long term credibility. It has been argued above that the donors, led by the IMF, do not provide this where governments are seen as accepting unwillingly the macroeconomic and structural changes required. It is very difficult for individual governments to create such confidence, particularly where they are the same governments which pursued quite different policies in the past. It almost certainly takes longer for individual governments to establish their credibility, than if they are locked in to a collective and convincing external constraint. The case of governments which are in open and acrimonious dispute with the IMF, a leading current example of which is Zimbabwe, really does seem impossible. The restraint attempted by the IMF is unlikely to be any more acceptable if imposed by some other external agency.

7. Conclusion: the need for a voluntary, collective, intra-SADC agency of restraint

It follows from these arguments that SADC governments must create a regional agency of restraint, by voluntary negotiated agreement, with credible sanctions against breaking its rules. In other words, SADC as a free trade area would have to develop a mechanism for constraining macroeconomic extravagance, not necessarily in order to *establish* a free trade area, but in order for it to have a chance of being *sustained*. This is essential for the non-SACU members to have a chance of attracting the investment that would enable them to take advantage of intra-SADC trade. Otherwise, a SADC free trade area will swiftly collapse.

The most obvious sanction would be loss of membership. Of itself, this might not be very threatening. However, if it meant exclusion from the South African market and South African investment, then it might be effective. Macroeconomic policy convergence may not be strictly necessary for countries within a regional trading arrangement to trade with each other using their existing economic capacity. The argument of this paper is that macro convergence around low rates inflation, with stable real exchange rates, *is necessary* where member countries do not have the economic capacity to take immediate advantage of new trading opportunities. Without this, they will not get their share of the short term benefits, and the free trade area will quickly fall apart. In order to create that capacity, private sector investment is necessary.

The necessary investor confidence willtake a long time to establish for individual countries, so the process must be accelerated. The potential benefits of a regional free trade area can only be secured if a *credible collective agency of restraint* is established by the SADC governments themselves. Other mechanisms might be able to contribute. For example, some form of partial investment guarantee to reduce the risks of South African investment in the SADC periphery could be positive. Such a scheme might attract donor support.

It would be absolutely essential that a SADC agency of restraint, and its sanctions, be

negotiated and accepted through conviction by the SADC member governments. Forcing governments into such an arrangement, whether using the muscle of the IMF or the regional dominance of South Africa, would not work.

Achieving voluntary agreement on the rules and sanctions necessary for macroeconomic stability in member countries, based on governments being convinced of their benefits, would probably take much longer than an agreement to reduce and eventually eliminate tariff barriers within SADC. This paper argues, however, that it is essential to set up such a collective agency of restraint, with credible sanctions, and therefore that the delay would be a price worth paying. Otherwise, a SADC free trade area will suffer the fate of other free trade areas in Sub-Saharan Africa; and a failed attempt would set back future attempts at regional integration by many years. It has taken more than 20 years for an attempt to be made to re-establish the East African Community.

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Appendix Table 1. Increase in the cost of a US $ 1962-1998 (selected African countries)

Country	Units/$ 1962	Units/$ 1998	Ratio 1998/1962
Liberia	1.00	1.00	1.00
CFA Franc	246.85	566.42	2.29
Ethiopia	2.4845	6.99	2.81
Mauritius	4.758	24.43	5.13
Gambia	1.784	10.22	5.73
Botswana	0.7143	4.68	6.55
Kenya	7.143	59.9	8.39
LNS	0.7143	6.27	8.78
South Africa	0.7143	6.27	8.78
Zimbabwe	0.7143	27.75	38.85
Malawi	0.7143	39.63	55.48
Sierra Leone	7.143	1550	216.99
Sudan	0.348	182.6	524.71
Nigeria	0.7143	566.42	792.97
Tanzania	0.7143	657.7	920.76
Congo (DRC)	64	137500	2148.44
Zambia	0.7143	2002	2802.74
Ghana	0.7143	2322	3250.73
Somalia	0.7143	2620	3667.93
Uganda (a)	7.143	127700	17877.64

Note: (a) actual rate for Uganda 1998: 1277 New Shillings (NS)/US Dollar; 1NS = 100 old shillings.
Source: International Financial Statistics; African Business October 1998

Appendix Table 2. GNP per head in SADC, 1980-98

	1980-89	1990-95	1996	1997
South Africa	2275	2908	3140	3140
Other SACU				
Botswana	1218	2763	2903	3036
Lesotho	450	592	670	679
Namibia	1430	1938	2080	2076
Swaziland	889	1133	1147	1161
Non-SACU SADC				
Angola	843	623	340	352
Malawi	171	203	206	213
Mauritius	1409	2947	3690	3840
Mozambique	131	87	90	96
Tanzania	262	143	130	130
Zambia	454	400	430	433
Zimbabwe	719	597	620	633

Notes: as for Table 1; 1997 calculated using growth rates from Table 1, adjusted for population growth. The Democratic Republic of the Congo and the Seychelles have been omitted from this table, and from discussion in the paper. The Congo remains irrelevant while the war continues, and the Seychelles is too small to make much difference to the argument.